

AUDIT REPORT

ISSUES REGARDING FEE STRUCTURE FOR THREE ENVIRONMENTAL MANAGEMENT CONTRACTS



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MEMORANDUM FOR THE DIRECTOR, OFFICE OF MANAGEMENT AND ADMINISTRATION

FROM: Phillip L. Holbrook (Signed)
Deputy Inspector General
for Audit Services
Office of Inspector General

SUBJECT: INFORMATION: Audit Report on "Issues Regarding Fee Structure for Three Environmental Management Contracts"

BACKGROUND

Over the last decade, the Department of Energy has been involved in a major effort to reform its contracting practices, including efforts to increase the accountability and enhance the performance of its facility management contractors. This includes contractors managing sites primarily devoted to environmental restoration activities. While implementing its overall reform strategy, the Department has increased fees available to these contractors. The objective of the Department's approach was to attract superior firms to perform the cleanup work and to provide greater financial incentives to encourage improved performance. We looked at three specific contracts (Rocky Flats, Oak Ridge, and Hanford) that had maximum available fees in excess of \$800 million over the lifetimes of the contracts. Actual fees earned will depend upon contract performance. The purpose of this audit was to determine whether the fee pools made available to these contractors were commensurate with the risks and responsibilities assumed.

RESULTS OF AUDIT

We were unable to determine whether fees made available to the three contractors were fully commensurate with the risks and responsibilities assumed. We found that there are many complexities in determining applicable fee, and that the documented record in certain circumstances was not adequate for us to make a determination. In addition, the Department used a different negotiating methodology for calculating available fee at each of the three locations: weighted guidelines at Rocky Flats, the management and operating fee policy at Oak Ridge, and competitive bid at Hanford. Based on a preliminary analysis of contract clauses and risks, we concluded that despite similarities among all Department facilities management contracts, available fees at Rocky Flats and Hanford tended to be higher than fees made available to other Department contractors. However, Department officials believed that, historically, fees made available to facility contractors may not have been adequate to attract best-in-class contractors. This position was reflected in the Department's recently issued report on *Analysis of the DOE Contractor Base*. In addition,

Procurement officials held the position that the fees made available to the three contractors reviewed were developed in accordance with applicable Acquisition Regulations, and, as such, were appropriate.

Although we were unable to fully satisfy the objective of our audit, during our review we noted that at one of the locations examined, Rocky Flats, available fee was established at a level substantially above the recommendation of a Government Cost Estimate and the Government's original "going-in" negotiating position. Management, in response to our inquiries, indicated that the Rocky Flats fee reflected the risks associated with the type of award and the unique challenges that the contractor would face in the execution of the contract. Although these are important points, the record of negotiation did not, in our judgment, set forth a clear and documented rationale for the Rocky Flats fee structure. Issues associated with establishing a clear rationale and cost/benefit analyses supporting available fees have been discussed in a number of previous Office of Inspector General reports.

MANAGEMENT REACTION

Department officials provided extensive written and oral comments in response to earlier drafts of this report. In these comments, management disagreed with our assessment and indicated that the post-negotiation memorandum provided a detailed record of the fee negotiation process.

In our view, however, the fee negotiation process was not documented thoroughly enough so that the Department's rationale was clear and transparent to ensure that the interests of the taxpayers were protected.

Attachment

cc: Assistant Secretary for Environmental Management

ISSUES REGARDING FEE STRUCTURE FOR THREE ENVIRONMENTAL MANAGEMENT CONTRACTS

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OVERVIEW

INTRODUCTION AND OBJECTIVE

Historically, the Department of Energy (Department) has relied on contractors to help execute its missions in energy, defense, sciences, and environmental restoration.

Beginning in the mid-1990s, the Department initiated several efforts to increase performance and accountability of its contractors. Most notably, the Department undertook a sizable contract reform effort and revised regulations to hold contractors more accountable for their activities.

In the midst of these efforts, the Department awarded contracts at Rocky Flats, Oak Ridge, and Hanford to operate sites primarily devoted to environmental restoration activities. At each of these locations, the prime contractor assigns tasks to subcontractors to accomplish a significant portion of the work. The objective of this audit was to determine whether fees made available to these remediation contractors were commensurate with their risks and responsibilities assumed.

CONCLUSIONS AND OBSERVATIONS

We were unable to determine whether fees made available to the three contractors were fully commensurate with the risks and responsibilities assumed. However, during the course of our review we noted that the Department's rationale for the available fee associated with the Rocky Flats contract was not well documented.

While we acknowledge that the concept of sufficient documentation is subjective in nature and that reasonable observers can disagree as to "how much is enough," a number of factors argue for a full and complete record of the Department's rationale in establishing fees at Rocky Flats. The factors include:

1. The contract was awarded on a non-competitive, sole-source basis to the incumbent contractor;
2. The fee package included a substantial increase in overall fees from those paid for prior work at the site; and,
3. The contract had a maximum available fee of \$460 million, or 11.6 percent of total contract costs, an extremely large figure relative to fees available to other Department facilities management contractors.

In making our observations and conclusions, we recognize that there are many factors involved in the negotiating process. As the Federal

Acquisition Regulation states, the Government should “offer contractors opportunities for financial rewards sufficient to stimulate efficient contract performance [and attract] the best capabilities of qualified large and small business[es]....” Further, in the final analysis, the fee structure in each contract is the result of what is often a complex and difficult negotiating process—the “give and take” on key contractual terms between the Department and prospective contractors. However, in our view, this process should be thoroughly documented so that the Department’s rationale supporting its strategy as it evolves during negotiation is clear and transparent to ensure that the interests of the taxpayers are protected.

Signed

Office of Inspector General

DOCUMENTATION ISSUES

Fee Negotiation Process

A Government Cost Estimate (GCE) recommended that the target fee¹ for the Rocky Flats contract not exceed 5 percent of the total cost of the contract². The GCE report further recommended that if the Department was “unable to attain [this] target in the negotiations...DOE should compete the contract [since]...at least three viable bids could be obtained via competition.” The GCE’s recommendation was supported by a comprehensive analysis which determined that the “DOE average fee [was] 4.1 percent.”

A senior member of the Rocky Flats negotiating team advised us that, given the type of the Rocky Flats contract (cost-plus-incentive-fee), the fee portion of the GCE was flawed and was, therefore, not considered a valid basis for fee negotiation. Specifically, officials did not believe that the authors of the GCE had significant experience in fee determination.

The Rocky Flats team initiated negotiation on a sole-source basis with the incumbent contractor and formulated a “going-in” target fee of 6 percent and an “upper negotiation” position of 8 percent. Ultimately, the target fee incorporated in the contract was 9 percent of total cost. The various fee ranges are illustrated in the following table.

Table 1: Fee Ranges Associated With the Rocky Flats Contract

	Minimum Fee	“Target Fee”	Maximum Fee
Government Cost Estimate	0	5%	[Undefined]
Negotiating Position “Going in” “Upper negotiation”	0 4%	6% 8%	10% 12%
Final Negotiated Fee Structure	3.77%	9%	11.6%

The shaded column illustrates that the target fee progressed from 5 percent to 9 percent, representing a difference of \$157 million in potential fee payments over the life of the contract. Even accepting

¹ “Target fee” is the fee to be paid if cost and schedule milestones are met. A minimum and maximum fee are established to create a range of incentive effectiveness for the range of probable cost both parties agree is reasonable given the uncertainties associated with the effort.

² The fee recommendation of the GCE was not developed using standard Government fee methodology, i.e., weighted guidelines, or the DEAR 970 fee methodology.

the negotiating team's assertion that the GCE was not valid, the Department did not adequately document, in our view, the rationale supporting the target fee's progression from the "going in" position of 6 percent to the 9 percent incorporated in the final contract. The need for a clear record on this matter was heightened by the fact that the negotiated target fee of 9 percent was substantially higher than the fee made available to the incumbent contractor for previous work performed at the Rocky Flats site.

The Rocky Flats contract also included what we judged to be a significant minimum fee. For this contract, the Department's "going-in" negotiation position was for a minimum fee of zero percent and a maximum of 10 percent of the total contract cost. In the final negotiations, the Department agreed to a minimum fee of 3.77 percent (\$150 million) and a maximum fee of 11.6 percent. Given that an unusually high maximum fee relative to traditional Department contracts was negotiated, the rationale for a minimum fee of 3.77 percent was not apparent to us, although the amount was less than the amount approved for negotiation.

Analysis of Departmental Position

In comments made during the audit, management stated that the Department's post negotiation memorandum contained an in-depth explanation of how they developed the target cost, target fee, and target schedule from the early part of the negotiations to the final contract. While we did find extensive notes on changes in the total Rocky Flats project cost, this was not the case for decisions regarding fee. The final negotiation memorandum only identified the "going-in" position, the contractor's requested fee, and the final negotiated fee of 9 percent. It did not fully explain or document changes in the fee objective. The fact that the contract was awarded on a sole-source basis, in our view, suggests that a higher level of documentation was warranted.

Management also indicated that the negotiated fees were reasonable, and the fee structure was approved at the "highest levels" in the Department. Our concern, however, is not with the approval levels, but with the requirement for a transparent, well-documented basis explaining the evolution of the fee determination process. In this case, fees were increased without, in our judgment, sufficient information to explain the basis for increases.

Finally, management pointed out that the minimum fee (3.77 percent) was less than the approved upper negotiation position (4 percent). While this statement is correct, we were still uncertain, based on the

records of negotiation, why the Department agreed to such a high minimum fee.

Need for a Clear Record

In response to the Department's contract reform efforts and previous audits relating to fees, Headquarters Procurement developed extensive guidance on contractor fees. The Department's Acquisition Guide and its 1998 Acquisition Letter provide specific criteria to be used in the formulation of profit objectives and the negotiation of fees. This guidance, combined with basic Federal and Department procurement requirements, particularly those relating to documentation, generally provide a sound basis for contractor fee determination.

In the case of the Rocky Flats negotiations, however, management told us that its key objective was to keep total costs to a minimum, not to minimize fee. Management noted that Government-wide regulations specifically state that negotiation objectives aimed merely at reducing prices by reducing profit are not in the Government's best interests and do not provide proper motivation to the contractor for optimum performance. We support the notion that completion of the task and overall cost containment are appropriate goals. Nevertheless, the unusually large negotiated fee at Rocky Flats, the progression of the fee objective during negotiations, and the sole-source nature of the contract all suggest that the Department fully document its rationale.

RECOMMENDATION

We recommend that the Director, Procurement and Assistance Management ensure that the negotiation process be thoroughly documented so that the Department's rationale supporting its fee strategy as it evolves during negotiation is clear and transparent to protect the interests of the taxpayers. Specifically, the Director should re-emphasize the need to thoroughly document the rationale for available fee determinations.

MANAGEMENT REACTION

Management provided extensive written and oral comments in response to earlier drafts of this report. The report reflects those comments. With regard to the negotiation of available fees at Rocky Flats, management asserted that the documented record was sufficient.

AUDITOR COMMENT

In our judgment, the fee negotiation process was not documented thoroughly enough so that the Department's rationale was fully explained.

Appendix 1

SCOPE

The audit was performed from October 1999 to December 2000 and included facilities management contracts awarded between 1995 and 2000 at the Department of Energy Headquarters, the Richland and Oak Ridge Operations Offices, and the Rocky Flats Field Office.

METHODOLOGY

To address the audit objective, we:

- reviewed Federal and Departmental regulations and guidance related to Federal contracting practices,
- reviewed performance measures in accordance with the requirements of the Government Performance and Results Act,
- compared contract elements and risks associated with each management contract,
- held discussions with Department procurement officials to determine methodologies and philosophies used to determine contractor available fees,
- reviewed fee comparisons made by the Department, and
- developed a comparison between actual available fees for the contracts reviewed and the amount that would be computed using the Department's fee policies.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to address the audit objective. Internal controls were assessed with respect to the Department's management contractor fee formulation process. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. We did not rely on computer-processed data. An exit conference was held with appropriate Headquarters officials on May 2, 2001.

PRIOR AUDIT REPORTS

OFFICE OF INSPECTOR GENERAL RELATED REPORTS

Bechtel Jacobs Company LLC's Management and Integration Contract at Oak Ridge, (DOE/IG-0498, March 2001). Bechtel Jacobs did not use competitive, fixed-price subcontracts or reduce staffing to the extent proposed. As of September 30, 2000, nearly three years after award of the contract, Bechtel Jacobs had subcontracted less than 60 percent of the original workscope. Further, the contractor had reduced staffing through transition to the subcontractors by only 58 percent. The Department could have saved an additional \$44.1 million in Fiscal Year 2000 had Bechtel Jacobs met the initial terms of its proposal.

The U.S. Department of Energy's Efforts to Increase the Financial Responsibility of Its Major For-Profit Operating Contractors, (DOE/IG-0432, November 1998). The Government was not adequately protected against contractor created liabilities on 16 of its 20 major for-profit operating contracts awarded by the Department of Energy; however, the Department increased fees from \$167 to \$204 million to compensate the 16 major contractors for assuming additional perceived risks.

The U.S. Department of Energy's Prime Contractor Fees on Subcontractor Costs, (DOE/IG-0427, September 1998). The Department did not adjust the fee bases of prime contractors to reflect actual efforts associated with oversight of subcontractors, which resulted in prime contractors being paid fee for the administration of subcontractors as well as for the subcontractor efforts. For 12 prime contractors audited, fees in a one-year period increased by an estimated \$34 million because fee bases were not adjusted.

Audit of Department of Energy Management and Operating Contractor Available Fees, (DOE/IG-0390, May 1996). The Department proposed revisions to its fee structure that would increase available contractor fees, possibly by as much as \$218 million per year. The revisions were initiated without conducting a cost-benefit analysis to demonstrate whether the changes were cost effective and would achieve envisioned benefits.

Audit of Implementation of the Accountability Rule, (DOE/IG-0339, January 1994). The Department spent \$22.8 million in increased contract fees and \$2.5 million in administrative costs to implement the Accountability Rule at five contractors with no conclusive evidence that the Accountability Rule was achieving its objectives.

GENERAL ACCOUNTING OFFICE RELATED REPORTS

Progress Made at Rocky Flats, but Closure by 2006 is Unlikely, and Costs May Increase, (GAO-01-284, February 2001). Although Kaiser-Hill has made significant progress toward cleaning up the Rocky Flats Site in the five years that it has been the major contractor, the majority and most complicated portions of the work remain to be done. Because of the significant and complex challenges that must be overcome, Kaiser-Hill and the Department are unlikely to meet the 2006 target closure date and related delays will increase the estimated \$7.5 billion clean-up cost.

DOE Needs to Assess the Impact of Using Performance-Based Contracts, (GAO/RCED-99-141, May 1999). The Department has not determined whether giving higher fees to encourage superior performance by its laboratory contractors is advantageous to the Government, despite a previous recommendation to develop criteria for measuring the costs and benefits of using higher fees.

Accelerated Closure of Rocky Flats: Status and Obstacles, (GAO/RCED-99-100, April 1999). While the Department and Kaiser-Hill have had some success in accelerating cleanup activities, it is questionable whether they can meet the Department's target date of 2006 for cleaning up and closing Rocky Flats at the costs and savings originally projected. They face numerous challenges, significant compression of schedule activities, and unresolved issues relating to the disposal of certain wastes and the site's condition at closure.

Modest Reforms Made in University of California Contracts, but Fees are Substantially Higher, (GAO/RCED-94-202, August 1994). The Department more than doubled the fees for its University of California contracts from \$13 to \$30 million under the contention that the University accepted additional financial risk. However, the Department acknowledges that paying fees in exchange for increased risk has been costly and has not improved the accountability of its for-profit contractors. Without criteria for measuring the benefits of having the university assume limited risks against the fees paid, the Department is continuing an approach that has so far been costly and ineffective.

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